J. Frankel

A Link Between Bush Tax Policy and Recession? October 30, 2003

The Commerce Department released October 30 its initial estimate of GDP in the third quarter. The numbers show an eye-catching economic growth rate of 7.2 %, and thereby make more plausible the claim that the country is in an economic recovery. The recession officially ended in November 2001 according to the Business Cycle Dating Committee of the National Bureau of Economic Research. But until now many people have not believed that we have been in a recovery, in part because employment has continued to fall. Indeed, Democrats will continue to blame White House economic policies for the loss of 2 ½ million jobs since President Bush assumed office.

In fact, good economic logic does not support the idea that Bush fiscal policies caused the weak economy of the last three years. Good economic logic supports, rather, a causal link between Bush fiscal policies and the *next* recession. The future downturn is likely to be far worse than the recent one.

The problem is the remarkably ill-conceived composition of the Bush tax changes. A fervent belief in low taxes is not enough; one has to know *which* taxes to cut. It is almost as if some aspects of the tax cuts were composed as if to *minimize bang for the buck*. Such measures as the decision to abolish estate taxes in the year 2009 and the reduction in dividend taxes, without offsetting future revenue gains, flunk most tests for an intelligent tax cut. On the one hand, the tax changes legislated in 2001 and 2003 were not designed to have most of their effect in the present, when we needed the boost. Moreover, they were designed to redistribute from poor to rich and from consumption to saving; thus they have provided a limited stimulus to consumption. They also created long-range uncertainty that makes planning difficult (nobody from either party expects the relevant tax law to remain as it is currently written) and have provided a very limited boost to investment. On the other hand, the dividend and estate tax measures were designed to produce large revenue losses later in the decade. Thus they minimize expansionary bang and maximize the long-run buck.

A sensible response to the 2001 recession would have included some tax cuts, but would have had a mix much better targeted to stimulate the economy today, without sacrificing long-term fiscal discipline. It could have given low-income workers a break from all federal taxes, and given some revenue to the hard-pressed states to spend on education and health. Such a policy would have had favorable effects on both demand and supply, and would have been more likely to produce a recovery strong enough to create jobs. Perhaps most importantly, a well-designed plan would have avoided setting the future economy on a long-term path of rapidly rising national debt. As it is, interest rates are likely to rise for the remainder of this decade, crowding out private spending, and slowing growth.

It is impossible to say when the next recession will come. But when it does, it is likely to be worse than the 2001 recession. Why? Precisely because we will enter it at a time when the budget deficit and national debt are already alarmingly high. Even the official White House projections no longer repeat their overly optimistic claim that the deficits will soon go away. Realistic forecasts call for deficits still worse than the official forecasts. Thus when the next recession hits, we will not have luxury of being able to cut taxes and increase spending as George II has done. If anything, we are more likely to be in the midst of raising taxes, as George I did in 1990. This will exacerbate the downturn, but -- like Argentina or Brazil in recent years -- we will have no choice. The resulting pain will make the economic travails of George II's first term pale in comparison.

Compared to the recessions of the early 1970s, 1980s, and 1990s, the loss in growth during 2001-2003 has been relatively mild. The 1990 recession, for example, arrived at a time when federal debt levels and inflation were rising. As a result, the Fed did not feel free to cut interest rates and Bush Senior did not feel free to cut taxes. Indeed, he bravely reversed his "no new taxes" pledge, raising taxes to address the budget deficit that Reagan had left him. It was the right thing to do, but at precisely the wrong time, exacerbating the 1990-91 recession, and famously costing him reelection.

The 2001 recession, by contrast, arrived at a time when inflation was at its lowest levels in 30 years and the budget was in record surplus. [The expansion of the Clinton presidency had been driven by booming private sector demand rather than by expansionary monetary and fiscal policy as in the earlier expansions.] This is why the Fed had the freedom to cut interest rates sharply in 2001, and why the government was able to cut taxes sharply. The magnitudes were big enough to dampen the severity and length of the downturn. But the composition of the tax cuts was designed so badly as to insure that whoever is president during the next economic contraction will not have this option available.

Jeffrey Frankel is Harpel Chair of Capital Formation and Growth at Harvard University. He was a Member of the President's Council of Economic Advisers in 1997-99, and on its staff in 1983-84.